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A PUBLICATION OF THE INTERNATIONAL MONETARY FUND
March 22, 1993

Hungary Cites Progress on Privatization, Outlines Priorities

Noting significant progress toward a market economy and the problems still posed by large state enterprises, two senior government officials candidly assessed Hungary's privatization efforts in a recent IMF Visitors' Center seminar. The discussion featured Tamas Szabó, Minister of Privatization, and Pál Teleki, Managing Director of the Hungarian State Holding Company, and also included Richard Ranken, Division Manager of the International Finance Corporation's Eastern European Department. Massimo Russo, Director of the IMF's European I Department, served as moderator.

How Hungary Has Privatized

An estimated one half of all the foreign direct investment made in Central Europe in recent years has gone to Hungary. With that investment and the growth of small and medium-size private businesses, the private sector in Hungary now accounts for a rapidly growing share of its GDP.

Was Hungary more predisposed to market reforms than its neighbors? Szabó believes that Hungary did have a foundation on which to build. He cited an entrepreneurial stratum that existed before World War II and that survived in the country's grey and black markets through more than forty years of a centrally planned economy. Szabó also paid tribute to Hungary's openness. Its tourism, its relations with the West, and its knowledge of the world enabled the country to keep in touch with other ideas and influences and lent it greater flexibility. *(please turn to page 85)*

Szabó: Hungary has opted to pursue privatization on a case-by-case basis.

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SELECTED TOPICS

Study Examines Effectiveness of Foreign Exchange Market Intervention

Breaking with the conventional wisdom, a new study published by the Institute for International Economics (IIE), a Washington-based think tank, maintains that intervention on the foreign exchange market can be an effective policy tool for determining how the market perceives the current stance of macroeconomic policy. Written by Kathryn Dominguez of Harvard University's Kennedy School of Government and Jeffrey Frankel of the Department of Economics at the University of California, Berkeley, *Does Foreign Exchange Intervention Work?* uses previously unavailable data on the daily operations of the German, Japanese, and U.S. central banks to demonstrate the importance of foreign exchange market interventions over the past decade.

Dominguez and Frankel review the history of intervention since 1973. They state that in the 1960s, when all major industrial countries had currencies that were convertible into foreign currency at a fixed exchange rate, intervention was not viewed as a discretionary policy instrument available in governments' "policy tool kits." Until the early 1970s, explain the authors, intervention was considered to be a "passive act in which governments were thought to have no choice: if the net supply for foreign currency coming from the private sector fell short of the net demand, at the particular exchange rate to which the country had committed itself, then the central bank had necessarily to make up the difference, supplying out of its reserves the foreign currency that the private sector wanted." All this changed when the Bretton Woods system of fixed exchange rates broke down in 1973.

Frankel: free-floating exchange rates may not function optimally.

To highlight the changes that have occurred since then, the authors follow the course of the U.S. dollar on foreign exchange markets from the early 1980s to the onset of the 1990s. The first Reagan administration, they remind us, supported a "strong dollar" during the early 1980s. Confronted with a rising U.S. trade deficit and concern about the possibility of protectionist trade actions by the U.S. Congress, however, the administration abruptly changed course in early 1985. This about-face was embodied in the so-called Plaza accord of September 22, 1985, under which finance ministers and central bank governors from the Group of 5 (G-5) countries agreed to a joint strategy of encouraging the depreciation of the U.S. dollar. Since that time the United States has maintained a readiness to intervene on the foreign exchange market for balance of payments reasons.

Dominguez: monetary and exchange rate policy should be better integrated.

Subsequent chapters focus attention on such issues as the effectiveness and types of intervention ("sterilized versus nonsterilized," for example), the utility of free-floating exchange rates, and matters of policy. The classic debate over free-floating exchange rates occupies a major part of the narrative. After surveying a large body of empirical research on the subject, the authors conclude that "it is no longer easy to claim that a freely floating exchange market necessarily functions in an optimal way." The interesting question for them is what, if anything, should be done about it.

In researching the subject, Dominguez and Frankel uncover a number of interesting results about how major intervention policies were

actually made. For example, they point out that the "decisions to depreciate the dollar at the Plaza and stabilize it at the Louvre, to judge from the communiqués as well as from informed reports on what went on inside the meetings, were made without much discussion of monetary policy." This seeming discrepancy, the authors maintain, is the direct result of "schizophrenic" policymaking. "Whether or not intervention in reality offers a tool for affecting the exchange rate that is independent of monetary policy," they write, "the policymaking apparatus is set up as if it does: exchange rate policy is discussed by the G-5 and G-7 [Group of 7] finance ministers, while monetary policy is discussed by central banks, for example, at G-10 [Group of 10] meetings ten times a year at the Bank for International Settlements in Basle."

Dominguez and Frankel conclude by assessing various proposals to reform the process through which intervention activities are carried out. They do not believe that major institutional changes in who makes intervention policy are necessary. "But we do endorse calls for better integration of the making of exchange rate policy and the making of monetary policy," the authors write. They also support recommendations for better integration of monetary and exchange rate policy in the G-7 process.

The authors likewise take issue with calls to expand significantly the group of people who make U.S. exchange rate policy beyond the "very small circle of senior government officials" in the Treasury and the Federal Reserve. "Our view," respond Dominguez and Frankel, "is that, under most circumstances, a broadening of the policy process in this way, in the sensitive and relatively technical area of exchange rates, could make things worse rather than better."

John Starrels,
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Record Global Borrowing In 1992, Says OECD

Despite poor prospects for the world economy, uncertainties in Europe, and interest rate and exchange rate tensions, borrowing on international capital markets hit a record $610 billion in 1992—a 16 percent increase over the previous year, according to the Organization for Economic Cooperation and Development (OECD) in its February issue of *Financial Market Trends*, a quarterly report on developments in global financial markets. The report adds, however, that the 1992 data "vastly overstate" the contribution of the international markets to net financing because these data include significant loan refinancing and do not take account of the record volume of outstanding bonds that were redeemed in the course of the year.

Discussing borrowing by groups of countries, the report points out that

- The demand for international financing continued to be strongly concentrated in the OECD area; OECD borrowing was $535.7 billion in 1992, or 88 percent of the total. Within the OECD, a striking development was the strong expansion of borrowing by U.S. residents, which rose by $95.0 billion (27 percent more than in 1991). Borrowing by U.K. residents also rose—for the third consecutive year—to $70.9 billion. In addition, German borrowers resorted to international capital markets on a significantly larger scale, raising $28 billion in 1992—almost 50 percent more than a year earlier. Fund-raising by Japanese entities, which had been the heaviest borrowers during 1989–91, totaled $75.5 billion in 1992, or 8.4 percent less than in 1991.
- After expanding by almost 60 percent in 1991, borrowing by developing countries rose only modestly (by 2 percent) in 1992, to $47.3 billion. (However, reconstruction-related loans to Middle Eastern countries, which accounted for $11 billion of the $46.2 billion borrowed by developing countries in 1991, totaled just $3 billion in 1992.) Asian and Latin American borrowers accounted for the bulk of developing country borrowing in 1992.
- Borrowing by Central and Eastern European countries declined to $1.5 billion in 1992—about 16 percent less than a year earlier and only about one-third the yearly average during 1988–90.

OECD Countries Dominate Borrowing on International Capital Markets

(billion U.S. dollars)

Country Group	1988	1989	1990	1991	1992
OECD area	413.8	426.5	384.4	457.9	535.7
Developing countries	22.5	21.8	28.6	46.2	47.3
Central and Eastern Europe	4.6	4.7	4.6	1.8	1.5
Others	12.6	13.5	17.3	19.0	25.2
Total	**453.5**	**466.5**	**434.9**	**524.9**	**609.7**

Data: OECD, *Financial Market Trends*, February 1993

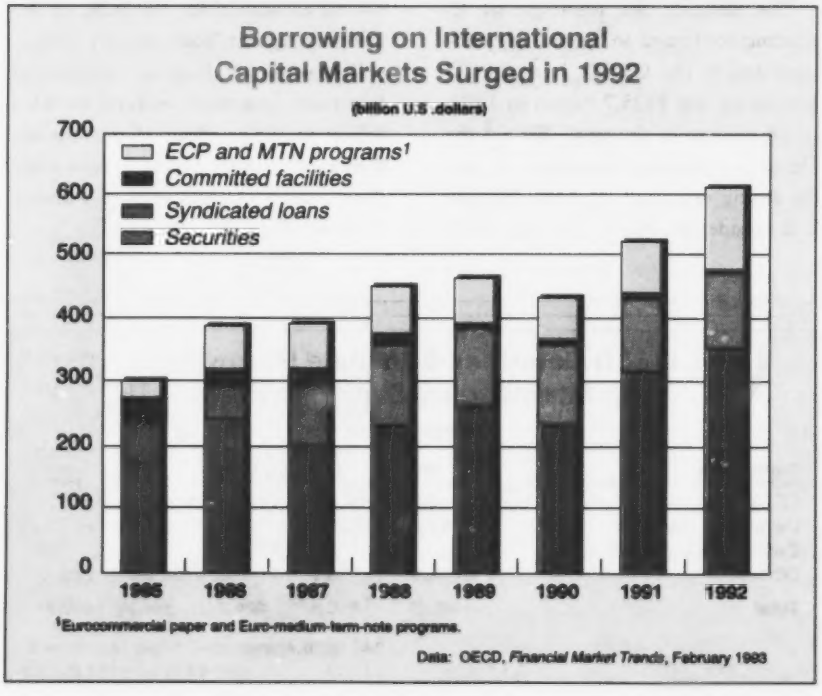
Turning to borrowing by instrument, the report notes that, after expanding by 30 percent in 1991, the volume of business in the bond markets totaled $334 billion in 1992 (or 55 percent of all borrowing)—a 12 percent increase over 1991.

New lending activity in the syndicated credit market remained weak, according to the report. The cautious attitude of banks and their emphasis on increasing rates of return continued to limit the scope for the market's growth, while resulting in a further stiffening of lending terms. Total syndicated loans amounted to $118 billion in 1992—about the same as in 1991—and this figure included an exceptionally large volume of refinancings.

A particularly striking feature in 1992, according to the report, was the expansion of Euro-medium-term note programs to $99.0 billion (16.2 percent of total borrowing), from $44.3 billion (8 percent of total borrowing) in 1991. By contrast, the value of Eurocommercial paper programs (which are borrowing instruments that have shorter maturities than medium-term notes) continued to decline in 1992, reaching $28.9 billion—about one half of the yearly totals of the late 1980s.

Prospects

Assessing short-term prospects for the global financial markets, the report projects that international securities markets are likely to remain buoyant. The Eurobond markets have entered 1993 on an "exceptionally strong footing," it notes, adding that all available indicators suggest "a volume of capital demand for 1993 much larger than in recent years." Borrowing requirements of OECD governments have risen considerably, and a substantial portion of these will have to be financed internationally. Non-OECD countries that have regained the creditworthiness to attract private and institutional investors are also expected to step up their borrowings on securities markets.



The report points out that, in addition to a higher volume of new demand, international bond markets will be confronted with rapidly growing refinancing needs. In 1993, the amount of scheduled payments on outstanding bonds is expected to be about $260 billion—and the total could be much higher if there are early redemptions, which is usually the case in an environment of falling interest rates. The report suggests that the competitiveness of the Eurobond markets should ensure that these markets recapture the bulk of security offerings connected with refinancing operations. Moreover, a large proportion of reflows from redemptions will be rolled over in these markets.

Two additional factors may enhance the supply of capital to the Eurobond markets, according to the report: the introduction of very large Euro-issues by sovereign borrowers, which investors find particularly attractive because of the high liquidity and scope for arbitrage that they offer; and the possibility of a sustained rally in the bond markets (given market expectations of a significant drop in European long-term interest rates), which would boost investor confidence.

Prospects for the syndicated loan market are less favorable, says the report. It notes that banks' strategic decisions will continue to be strongly influenced by considerations of credit quality and balance-sheet consolidation. Most banks will remain "very cautious" in making loans, which will limit the expansion of the syndicated market.

Finally, the report notes that the Euronote market has become much broader and deeper in recent years, with business volumes having grown rapidly. The momentum for further growth will continue to come from the market for Euro-medium-term notes, the report points out.

Hungary's State Holding Company Designed To Speed Up Privatization Process

(continued from front page) Hungary's efforts to reform its socialist economy began earlier than in the rest of Central Europe. "We had," Szabó noted, "a two-tier banking system before any other countries in the region, and we introduced distribution and personal income taxes earlier." Hungary also began to re-evaluate its relationship with its enterprises as early as 1985. Without broader changes in the economy to underpin these reforms, the entrepreneurial self-management initiatives ultimately proved a blind alley, but the experiment did afford enterprise managers the opportunity to draw back from the immediate influence of politics and begin to concentrate on managerial issues.

In 1990, when Hungary began the methodic transfer of ownership, it based its efforts, Szabó observed, on three complementary efforts: legislation, liberalization, and privatization. Legislation stipulated what part of state property would go into whose hands by what process and through what technique. Liberalization brought foreign capital into Hungary and induced, he noted, "an unimaginable explosion within the private sphere."

In giving shape to its privatization policy, Hungary, unlike many other Central European countries, opted to sell rather than distribute shares in its state enterprises. Hungary wants to realize a cash surplus from these sales, Szabó said, and is basing privatization on the submission of competitive bids and tenders. The country is also trying to meet a complex set of objectives. He noted that in some instances it may not readily be able to harmonize, for example, making money and ensuring environmental safety. For this and other reasons, Hungary has carefully weighed economic, social, and environmental concerns in each decision and has pursued privatization on a case-by-case rather than a mass basis.

The private sector now accounts for a rapidly growing share of Hungary's GDP.

Szabó also believed Hungary's efforts to seek worker input have contributed significantly to the effectiveness of its privatization efforts. "It is extraordinarily important," he said, "that amidst this merciless change we are able to operate institutionally as partners." One of the very first steps Hungary took in the privatization process was to create a council that would coordinate the interests of groups, such as labor, that would be affected by the economic transformation. The council established minimum wages and other economic programs, and has also been influential in restratifying ownership. Under recent legislation, employees participate in the process of privatization, and coordination of interests has been made compulsory. Government recognition of the importance of worker involvement is a critical factor in achieving "societal peace," Szabó said.

State Holding Company

Why create a state holding company while you are trying to privatize? According to Teleki, Hungary is anxious to transform its economy, but has lost its traditional market for products and services—the former Soviet Union. In creating a holding company, Teleki said, the Government is trying to provide the conditions some companies need to get back on their feet and to ensure that certain services upon which the population depends remain available.

Hungary intends its new state holding company to provide efficient market-oriented supervision for that portion of the Government's share portfolio that is not scheduled for early privatization. It is explicitly not designed to intervene in the day-to-day operations of the companies in its portfolio, and is meant to speed up privatization wherever possible.

Some of the company's holdings, for

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example, in energy, are strategic. Hungary remains a net importer of oil and gas, traditionally from the former Soviet Union. Hungary will retain a percentage interest in energy companies to "ensure that it is not subject to the vagaries of the international scene," Teleki said.

The Government is also concerned with other important, but less explicitly strategic, issues. Teleki noted, for example, that his company's holdings include the country's 37 research and development institutes, which currently employ a large, highly skilled, and highly specialized staff. While private industry develops, the Government is hoping to retain their skills and provide the means to have this group gradually make the transition to private enterprise.

Teleki: the state holding company will try to speed up privatization.

One of the most important considerations for the new state holding company, Teleki said, was what type of investment to seek. Technology is clearly important, but so, too, is managerial input. "Out of 160 companies," he noted, "no more than 3 or 4 have proper management. It is very critical that our holding company, as a partner, very carefully searches out the right type of managers to run companies and make them accountable."

Teleki also stressed the social issue—what the holding company can do to ease the transition from full employment to a market economy in which unemployment, sometimes double-digit unemployment, occurs. "We just finished a deal with ALCOA," Teleki observed, "where we took lesser value because ALCOA promised to keep a larger number of people working for a specific period of time. It gave the company a chance to build down over time rather than create an immediate crisis."

The Future of Privatization

Hungary, like many of its neighbors, has had to cope with several major difficulties during privatization. It experienced an unprecedented oversupply of assets—an oversupply that has affected not only Hungary but all of Central and Eastern Europe.

In light of rapidly changing economic circumstances, Hungary has also had difficulty in determining the market value of its assets. A recession has further compounded the problems associated with inflation, high nominal and real interest rates, and a heavy tax burden. Finally, the sheer size of the administrative and legal aspects of the transition has stretched the country's available human resources to the limit. But Hungary has clearly made progress, emphasized Szabó, and is committed to following through on its initiatives.

What are Hungary's priorities in 1993? The real challenge, according to Ranken, "is not really small or medium businesses, where there has been tremendous progress, but in big projects." For Hungary, 1993 will be, Szabó assured his audience, the year of the big project. Bank privatization is scheduled to begin, and the country hopes to make major advances in privatizing telecommunications. The public services sector will also, he noted, be prepared for privatization.

Utilities are slated for privatization, Teleki confirmed, but the process will be very intricate, require complex regulation, and take some time. The Government intends, he said, to retain only a 25 percent share in electrical and gas distribution. It is planning a similar arrangement for water works, where the larger regional water companies have to be reorganized into smaller entities at the municipal level. Hungary is moving faster to privatize telecommunications and hopes to complete the process by the end of the year, Teleki said.

There are uncertainties, Szabó admitted, but "we have taken strong measures to stop the debt problem. The bankruptcy law that we introduced in 1990 has had strong effects; existing losses have been concentrated in bank portfolios, where they are a liability; and a debt consolidation mechanism has been established." Hungary has also moved to ease financial uncertainty, expanding reserves, which had amounted to $600 million in 1990, to more than $5 billion and recording, for a second year in a row, a positive balance of payments.

In spite of the uncertainties, Hungary should not hesitate to privatize, Szabó emphasized. "New foreign investment and private enterprise have created a dynamic thrust to the economy. No doubt it appears as an isolated island now, but in essence it has counterbalanced the collapse of Eastern Europe. I think it is a miracle that we stand as we do."

Sheila Meehan,
Assistant Editor, *IMF Survey*

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IMF ACTIVITIES

Managing Director's Address . . .

Camdessus Outlines Global Economic Problems And Opportunities in 1993 and Beyond

Following are excerpts from an address given by IMF Managing Director Michel Camdessus at the Grande Conférence Catholique, Brussels, Belgium, on March 4, 1993:

Before I begin my remarks, I would like to ask your permission to pay homage to one of your eminent compatriots who has just passed away. Baron Triffin, first within the International Monetary Fund and subsequently throughout his entire career, was one of the individuals who contributed the most to our understanding of the international monetary system; moreover, he had a profound influence on the evolution of the system in the post-war period.

He was a true European, and, more than this, he was a true "citizen of the world." I am convinced that the emphasis I wish to place this evening on the need for renewed international cooperation would have met with his approval.

I propose to examine with you this evening a strategy for world growth appropriate now, in the early part of 1993.

Camdessus: the seeds of opportunity have been sown.

Let us examine for a moment the range of problems and opportunities before us; perhaps we shall be able then to identify better the paths toward progress: namely, cooperation and solidarity.

Problems and opportunities: the first, it must be acknowledged, are more obvious than the second. The problems are with us here and now, and perhaps tomorrow as well if we fail to attend to them; the opportunities, on the other hand, are for tomorrow, but the seeds of opportunity have already been sown and we need only nurture them to maturity. Problems? Let us examine five major problems, which together create a sixth, because they undermine confidence.

The first, obviously, is weak growth in the industrial countries. It is true that in the United States there have been increasingly encouraging signs of a strengthened recovery; but even there, doubts persist about the sustainability of the expansion and the prospects for a reduction in unemployment to more tolerable levels. Meanwhile, recession is now striking Japan and Europe, with unemployment in Europe continuing to increase rapidly. According to our projections, output in the industrial countries will grow by 1½ to 2 percent in 1993. After several years' dismal performance, growth in Europe will be barely positive: below 1 percent. It is hoped, of course, that there will be a turnaround in 1994, but we know full well that from now on, growth alone will create fewer jobs than it once did.

Second, the recent turbulence in exchange markets and destabilization of the European Monetary System (EMS). The exchange market crises of the past six months have disrupted the EMS, raised doubts about progress toward monetary union in Europe, and given rise to broader uncertainties. In recent weeks, tensions within the exchange rate mechanism have eased considerably, but there are still large interest rate differentials, indicating that confidence is far from fully restored.

The third object of concern is increased tensions in international trade. The Uruguay Round remains deadlocked, and while everyone is repeatedly stressing good intentions, the only real news is of countervailing and antidumping measures and voluntary export restraint agreements. At best these are but palliatives, and in some cases are tantamount to out-and-out protectionism.

Fourth, Russia and the other formerly centrally planned economies face problems in their transformation efforts. I am happy to say that several Eastern European countries have been showing early signs of success, and that in Eastern Eu-

rope as a whole (excluding the former Soviet Union), moderate growth is expected in 1993, for the first time in five years. But because they started their transition later and inherited problems of unprecedented scope and seriousness, most countries of the former Soviet Union still face formidable difficulties. In Russia in particular, hyperinflation and its customary companion in arms, capital flight, are making it particularly urgent to adopt wide-ranging macroeconomic stabilization measures and structural reforms, which are difficult to introduce in the midst of unrelenting institutional debate. Will Russia manage to do what is required, and will the West, severely hampered by its own problems, manage to provide the resources necessary to improve the odds in favor of democracy and peace?

Fifth, the situation in the developing countries is mixed. A number of countries have registered notable successes. Growth in the developing world as a whole picked up last year in spite of the slowdown in the industrial countries, and our projections indicate that developing countries' growth in 1993, again at almost 6 percent, will exceed that of the industrial countries for the fifth straight year. However, this overall performance is attributable in large measure to the vibrant economies of Asia and to the successes of those countries, in Latin America in particular, that have steadfastly pursued structural adjustment programs with the support of the international community. While such successful performances have characterized roughly half of the developing world in terms of GDP, the other half represents what I shall

Currency Units per SDR

Currency	FEBURARY 23	24	25	26	MARCH 1	2	3	4	5	8
Deutsche mark	2.25128	2.24051	2.25038	2.26093	2.26966	2.26186	2.26648	2.27329	2.27451	2.26754
French franc	7.66438	7.62147	7.65876	7.69102	7.69605	7.69071	7.67796	7.67339	7.7115	7.75988
Japanese yen	161.578	162.368	162.32	161.967	163.1	163.096	161.743	161.312	160.748	161.52
Pound sterling	0.953466	0.951705	0.954902	0.954872	0.956659	0.954267	0.950443	0.953337	0.94901	0.951051
U.S. dollar	1.38634	1.38774	1.38145	1.3761	1.37405	1.37634	1.38242	1.3811	1.381	1.37522
Argentine peso	...	...	...	1.38234	...	...	...	...	1.37893	...
Australian dollar	2.0028	1.99761	1.99085	1.97801	1.95762	1.95336	1.95533	1.95153	1.9407	1.94956
Austrian schilling	15.8528	15.7683	15.8176	15.9132	15.9678	15.9174	15.9421	16.0042	15.9947	16.0804
Bahrain dinar	0.521264	0.52179	0.519425	0.517414	0.516643	0.517504	0.51979	0.519294	0.519256	0.517063
Bangladesh taka	54.0673	54.1219	53.8766	53.6679	53.586	53.6773	53.9144	53.8629	53.859	53.6336
Belgian franc	46.4944	46.2673	46.282	46.5259	46.8001	46.5444	46.5564	46.8642	46.8539	47.06
Brazilian cruzeiro	...	26189.3	26751.	26964.6	27284.5	27612.	28017.9	28276.4	29560.9	28729.
Canadian dollar	1.73944	1.75161	1.73179	1.71971	1.71628	1.7174	1.72346	1.71574	1.72266	1.70961
Colombian peso	1146.95	1148.63	1143.96	...	1139.01	1141.47	1147.01	1146.4	1146.81	1142.51
Danish krone	8.66611	8.62203	8.60989	8.67012	8.71697	8.66957	8.67399	8.72855	8.72999	8.76834
Finnish markka	8.1331	8.16907	8.18537	8.18835	8.22108	8.2023	8.19623	8.24669	8.25327	8.27594
Greek drachma	304.896	304.054	304.789	305.859	...	305.823	305.584	307.233	307.236	308.764
Indian rupee	36.3221	36.3566	36.194	36.0538	36.0001	44.1255	43.9748	44.0295	43.7777	...
Indonesian rupiah	2864.18	2865.68	2854.08	2844.4	2841.54	2846.27	2857.46	2854.73	2854.53	2843.95
Iranian rial	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3
Iraqi dinar	0.430954	0.431389	0.429434	0.427771	0.427133	0.427845	0.429735	0.429325	0.429194	0.427497
Irish pound	0.928125	0.92479	0.929018	0.932001	0.932508	0.928579	0.930985	0.931728	0.934814	0.940707
Italian lira	2191.69	2209.07	2174.73	2187.59	2169.26	2158.53	2163.47	2160.01	2160.22	2169.27
Korean won	1103.94	1103.95	1098.67	1094.69	1092.23	1094.05	1098.19	1097.28	1095.69	1090.27
Kuwaiti dinar	0.423687	0.424315	...	...	0.420803	0.421256	0.421845	0.421443	...	0.419923
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.64399	3.64559	3.63114	3.62396	3.61856	3.62253	3.62374	3.6171	3.61477	3.60198
Maltese lira	0.524394	0.526836	0.526467	0.526173	...	0.527131	0.526155	0.526065	0.526637	...
Nepalese rupee	69.4972	69.5674	69.2521	69.0114	68.9636	69.0785	69.3837	69.3174	69.3124	69.0223
Netherlands guilder	2.54282	2.52763	2.53952	2.54689	2.55051	2.53907	2.5449	2.54233	2.55402	2.5729
New Zealand dollar	2.65277	2.64432	...	2.62715	2.61973	2.60819	2.6202	2.61622	2.60222	2.61002
Norwegian krone	9.62605	9.58275	9.59003	9.63683	9.66713	9.61305	9.61542	9.67046	9.66079	9.6953
Omani rial	0.533048	0.533586	0.531168	0.52911	0.528322	0.529203	0.53154	0.531033	0.530995	0.528772
Pakistan rupee	36.4625	36.5193	36.3538	36.213	36.1591	36.2883	36.5179	36.483	36.4804	36.3277
Portuguese escudo	...	206.947	206.875	207.864	207.901	207.575	207.652	209.039	210.01	210.035
Qatar riyal	5.04828	5.05137	5.02848	5.009	5.00154	5.00988	5.03201	5.0272	5.02884	5.0058
Saudi Arabian riyal	5.19184	5.19709	5.17353	5.15349	5.14582	5.15439	5.17716	5.17222	5.17185	5.1502
Singapore dollar	2.27471	2.27659	2.26655	2.26382	2.26237	2.2638	2.26924	2.2697	2.26967	2.26581
South African rand	4.33301	4.34154	4.32877	4.32371	4.33307	4.33616	4.3567	4.3622	4.37156	4.36214
Spanish peseta	163.325	163.226	162.198	162.724	162.55	161.981	162.6	162.5	163.068	162.771
Sri Lanka rupee	64.4648	64.6687	64.4448	64.2639	64.2368	64.3439	64.6281	64.6355	64.5618	64.4291
Swedish krona	10.6079	10.7331	10.8232	10.7074	10.7499	10.6123	10.6433	10.6365	10.5861	10.5644
Swiss franc	2.07258	2.06815	2.08516	2.09635	2.10298	2.09823	2.09755	2.10549	2.10948	2.11674
Thai baht	35.1853	35.2347	35.1165	34.9942	34.9971	35.0416	35.1411	35.0799	35.0636	...
Trinidad and Tobago dollar	5.90667	5.91264	5.88584	5.86305	5.85431	5.86407	5.86997	5.88435	5.86392	5.8593
U.A.E. dirham	5.09925	5.09439	5.0713	5.05166	5.04414	5.05254	5.07486	5.07002	5.06965	5.04843
Venezuelan bolivar	...	114.211	113.831	113.597	113.634	113.892	114.603	114.631	114.761	114.556

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

call the continent of woe, where too many countries, particularly in Africa, remain in critical shape, rooted in poverty, and beset by the consequences of poor economic policies.

These are five immense problems, so it should come as no surprise that their combined effect has, in most parts of the world, led to a deep crisis of confidence that is sometimes compounded by a crisis in respect of the credibility of our institutions and our strategies. This, then, is the dark side of the picture, which we know too well.

And the opportunities? Well, if we can turn away from the litany of our misfortunes, and lift our eyes to the outlook for the medium term, the contrast is striking. While I would not be so bold as to say straightaway that the opportunities will win out over the risks, five factors can be identified that point to recovery.

1. First, and of course there is room for debate on this score, there has been an increasing understanding on the part of our leaders that the time for fiscal irresponsibility has passed, and also that if we really want growth and job creation, we have to get back to the drawing board to work out a number of structural reforms in respect of saving and the labor market that in the past have been more or less taboo. While this emerging awareness is an opportunity that has grown out of crisis, it is an opportunity not to be missed.

There has been an increasing understanding . . . that the time for fiscal irresponsibility has passed.

2. In support of strategies to put government finance back on a sound footing, the opportunities to reduce military spending, and to reduce it everywhere, should make it possible for sound budgetary practices to be restored without, among other things, a negative impact on social priorities, but instead in a manner consistent with correcting the other deficit that was characteristic of the 1980s in many countries, the social deficit and the inadequacy of investment in human resources. (Obviously, I am not overlooking the fact that, in the short term, reducing the size of the military-industrial complex always starts with significant budgetary costs of conversion.)

3. I have mentioned the perils in the area of world trade, but let us not forget the promises held out by the Uruguay Round. The experience of the postwar boom years reminds us that every phase of world trade liberalization has brought with it gains in productivity, growth, and employment throughout the world, and particularly in countries that are extensively involved in international trade.

4. And why would we Europeans forget that the single market, strengthened by economic and monetary union, holds out another set of promises, which I would hope can be repeated in the regional integration efforts now under way in other parts of the world.

5. And, finally, there are what I will call the growth opportunities arising from the *practice of solidarity*, in two areas:

• first, in the developing world: the end of the debt crisis, which has resulted from debt-reduction operations and courageous stabilization and reform programs, is of considerable significance. Thanks to these operations and programs, and to the wisdom and courage of the leaders who have backed them, half the developing world is registering satisfactory growth and is already serving as an engine of growth for neighbors, a process that will strengthen over time;

• second, there is the great potential for medium- and long-term growth in the countries of Eastern Europe and the former Soviet Union, provided we are able to help them integrate successfully into the world economy. The stakes involved here, starting in the unified Germany, are extraordinarily high, and go well beyond economic growth alone. Should not this prospect alone help lift the gloomy spirits of our continent, despite the unavoidable difficulties of transition that these countries, and we ourselves, face?

Thus, there are five opportunities! What can be done, then, to overcome our problems and seize these opportunities?

With regard to *cooperation in a worldwide perspective*, I shall indicate only two major areas of application:

• the multilateral trade negotiations of the Uruguay Round;

• a G-7 [Group of 7] initiative for sustainable growth.

From the standpoint of the world economy as a whole—and particularly, whether this is recognized or not, for Europe, the world's largest trading partner—the number one imperative today is the successful completion of the Uruguay Round without further delay. It is here, in the area of multilateral trade negotiations, that I see the most urgent need for decisive international cooperation efforts. Governments cannot allow themselves either to miss this opportunity or to cede to the protectionist pressures which, as always, arise from weak growth or trade imbalances. Certainly no country, no interest group, can get everything it wants. But we have to look beyond individual interests and see what the world as a whole stands to gain, or to lose in the event of a failure. Improvement in the economic climate—reduced uncertainty, greater confidence, and clear signals for investors, producers, and traders—depends on the successful conclusion of these negotiations. While one can always view such aggregative studies with skepticism, one study by the OECD [Organization for

Economic Cooperation and Development] estimates the potential gain in world economic activity and efficiency at close to 1 percentage point of GDP. One can quibble about this figure, and commentators have hardly refrained from doing so, but that there would be a significant positive effect is undeniable. Vital issues are at stake, including opportunities for structural reform in the developing countries and the economies in transition. Finally, let us think of the cost in terms of confidence, and delayed economic stimulation, of the hairsplitting and other forms of foot-dragging that have sometimes held up or paralyzed these negotiations. If the negotiations were to fail, there would be an avalanche of trade disputes, reprisals, and counterreprisals, and the inexorable return to protectionism. No one wants to contemplate this possibility, and all are bracing themselves instead for a last hard push. One phrase we often hear is "better no agreement than a bad agreement"; now, however, we should instead say "better an early agreement than a perfect agreement." If there is no agreement in the offing, I must confess that I fail to see what possible credibility there would be to any agreement among the major industrial countries on the concerted revitalization of the world economy. Any "grand design" for the world we live in requires a successful Uruguay Round.

The number one imperative is the successful completion of the Uruguay Round.

Cooperation for the resumption of lasting growth, and hence growth with stability, at the initiative of the G-7. This is, of course, the topic of the day. Let us note that the idea of such an initiative is singular in three respects. *First*, its key components are quite well known, even though they have yet to be debated explicitly. Commentators rattle them off every morning. These necessary elements of cooperation have the remarkable characteristic of being essential both for ensuring steady growth in the medium term and for facilitating the reversal of the economic cycle in the short term. There are five such elements.

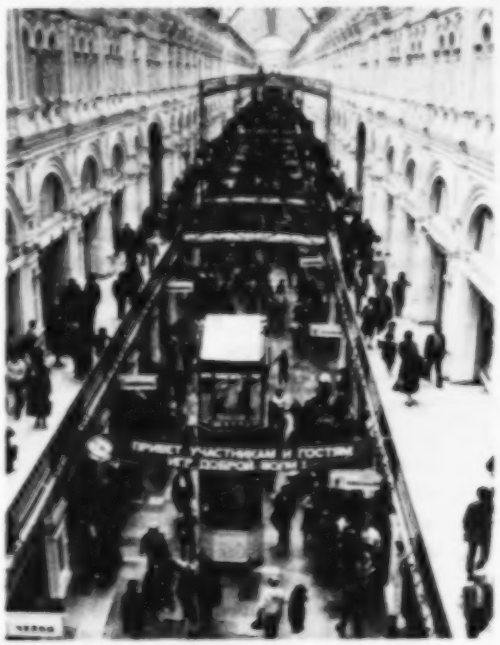
1. In Europe, short- and medium-term interest rates, the major obstacle to growth, must come down. We all know of Germany's crucial role here. Monetary conditions in Germany have been eased somewhat in recent months, and I consider this to be fully justified by the waning of domestic inflationary pressures. Although price increases in Germany have remained large, the pronounced slowdown in activity, early indications of a sharp decline in monetary growth, and favorable developments on the wage front—most notably the 3 percent public sector pay deal—should soon be reflected in a moderation of inflation. There should therefore be scope for a further significant reduction in interest rates in the near future. Apart from being appropriate to Germany's domestic requirements, this should contribute to a further easing of tensions within the EMS and to an easing of monetary policies throughout the continent, where, as in most other industrial countries, I might add, inflation has now been brought down to historically low levels. We shall have to learn to keep it there.

But we should aim for more than a slow and limited reduction in interest rates in Germany. Late last year, I voiced my desire for a decline in real interest rates on the order of 2 percentage points. For this to be possible there is a need for more effective fiscal consolidation in Germany. Progress in this regard, together with the other elements in the proposed solidarity pact, would both contribute to the lowering of interest rates and improve medium-term growth prospects. Elsewhere in Europe, lower interest rates call for stronger fiscal policies in countries where excessively large public sector deficits have been allowed to develop, and for other policies specifically directed at boosting saving and investment. Let me mention in particular the major challenge of deficit reduction being faced by the Italian Government, as well as the need to cut back the large budget deficit that has recently emerged in the United Kingdom. For these and other member countries of the EMS, fiscal consolidation is of course part of the convergence of economic policies and performance that is essential if credibility is to be restored to the system, and which is required by the Maastricht Treaty.

2. I turn now to the second component of a concerted recovery strategy. In the countries to which I have just referred, and everywhere else that public sector deficits have been allowed to develop—deficits which, owing to the impact on long-term interest rates and the costs of refinancing the public debt, absorb too much saving and stifle growth—it is necessary without delay, and without being haunted by the fear of short-term contractionary effects, to convince the markets of governments' resolve to attack the problem by taking vigorous, immediate measures. In this regard there is an obvious and striking contrast between the United States and Europe. The United States has the good fortune to be able to embark on its fiscal consolidation effort during a period of cyclical recovery, while the European countries are obliged to show their resolve at a time when the cycle is less in their favor. Nevertheless, they cannot delay initiating the correction. For the United States, the program has been announced. Since the U.S. administration has been urged for so long to come to

grips with the fact that the only solution to its most urgent problem—the lack of saving and investment—is to reduce its fiscal deficit and, to the extent necessary, to raise taxes, it would be inappropriate to mince words now. The economic program presented by President Clinton represents a considerable effort in this direction. Additional measures will be needed in due course in order to bring about the true fiscal consolidation that is required in the medium term. But by addressing its problems head on, the United States is making an immediate and not insignificant contribution to a global recovery strategy.

3. In Japan, as in the United States, short-term interest rates have been reduced to historically low levels to support demand. But in contrast with the United States, growth in Japan has recently weakened more than expected, and there are no signs of an upturn. Also in contrast with the United States, and indeed most other industrial countries, Japan's successful fiscal consolidation in the period of expansion in the late 1980s has put it in a position to be able to take stimulative fiscal measures. Indeed, a major fiscal package was introduced last August, and some of the stimulus from it is still in the pipeline, owing to delays in implementation. In these circumstances, it is clear that the Japanese contribution to a joint initiative must consist in urgently examining additional fiscal measures that would enable the Government to tackle persistent signs of weakness without delay. Let me add that current plans to recycle a portion of Japan's balance of payments surpluses to the developing countries, particularly the poorest African and Asian countries, should be especially encouraged.



The GUM department store in Moscow: Russia's economy faces stiff challenges.

4. Fiscal consolidation, lower interest rates, and stronger growth are not sufficient to create the conditions needed for a substantial and lasting reduction in unemployment, particularly in Europe. All *structural rigidities*, which so seriously weaken the potential of growth to create jobs, must be more vigorously tackled. Bold steps must be taken to initiate far-reaching reforms, to make labor markets more flexible, and to eliminate the large number of regulatory obstacles to free enterprise. Though they might not have any immediate practical impact, these measures can have considerable confidence-raising effects. I am well aware that many taboos are involved here, but were not tax hikes a taboo in the United States? Is it not one of the objectives of international cooperation to help each country abandon its own sacred cows while other countries, with a common purpose, do the same?

5. Finally, here in Europe: strengthen the EMS. Speaking here in Brussels, I think I can be brief. The [European] Community recently took an important growth initiative in Edinburgh, but it must also strengthen the EMS. The September crisis was serious, and it taught us a lot. First, that there is still a lot of ground to be covered between the first and the third stages of Economic and Monetary Union and—a useful reminder—that exchange rates cannot be fixed without a strengthening of the convergence process. Second, it showed us that in globalized markets, where more than a trillion dollars are traded every day, four norms of economic and financial good conduct are vitally important:

- strict macroeconomic policies that support exchange rate parities;
- the overall strengthening of structural policy efforts aimed at greater flexibility, for if unemployment rates cannot be made to converge at lower levels, economic union will always be vulnerable;
- close coordination among monetary authorities; and
- last, timely exchange rate realignments that are carried out quietly and smoothly, to the extent possible, when parities have become too far out of line with the fundamentals.

After this list of essential measures, which are hardly surprising, let us note the other two key features of any proposed growth initiative today:

- One is that, we know that in any event, the measures I have just indicated will be taken sooner or later because the need for them is clear. However, we have everything to lose by taking them too late and as isolated, disorganized initiatives.
- These measures, which are obligatory and which will be taken, must all be implemented without delay in an intense, concerted effort. It is striking how different the impact of fast and highly coordinated action can be in terms of its results and its effects on confidence.

From the Executive Board . . .

The Gambia: Article VIII Status. The Government of The Gambia has notified the IMF that it has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval. The Gambia is the seventy-seventh member of the IMF to assume Article VIII status.

The two main purposes of the IMF, as stated in its Articles of Agreement, are to facilitate the expansion and balanced growth of international trade, and thereby contribute to high levels of employment and real income; and to assist in the establishment of a multilateral system of payments in respect of current transactions between IMF members. In seeking to achieve these objectives, the IMF exercises firm surveillance over the exchange rate policies of its members and oversees the elimination of exchange restrictions that hamper the growth of world trade.

By accepting the obligations of Article VIII, The Gambia gives confidence to the international community that it will pursue sound economic policies that will obviate the need to use restrictions on the making of payments and transfers for current international transactions, and thereby contribute to a multilateral payments system free of restrictions.

The Gambia has been a member of the IMF since September 21, 1967, and its quota is SDR 22.9 million (about $32 million).

Press Release No. 93/9, March 2

Poland: Stand-by Credit. The IMF has approved a stand-by credit for Poland, authorizing purchases up to the equivalent of SDR 476 million (about $655 million) in support of the Government's economic and financial program for 1993. The Polish authorities have requested that 25 percent of each disbursement under the credit be set aside for debt-reduction operations. In addition, the IMF will be prepared to consider an augmentation in the amount of the stand-by credit in the event that financing arrangements are concluded with commercial bank creditors for debt-service reduction and upon determination by the IMF that such arrangements are consistent with the objectives of the program.

The overall objectives of the Government's program for 1993 are to achieve a further and lasting reduction in inflation and to create conditions for sustained high growth through prudent financial policies and continuing reform of the state enterprise sector. Since Poland adopted a sweeping economic reform program on January 1, 1990, much has been achieved, although the transformation to a market economy has been more difficult than anticipated. The decline in output during the first two years of reform was dramatic, and building the institutions necessary to underpin a market economy has proved to be arduous and time-consuming. Nevertheless, in 1992, inflation slowed further, industrial production rebounded strongly, the trade balance strengthened, international reserves increased, and the private sector continued to flourish.

To achieve its program objectives, the Government aims to reduce the state budget deficit to 5 percent of GDP in 1993 from 7.2 percent in 1992 through a combination of measures, including expenditure reforms and an overhaul of the tax system, that are designed to control inflationary pressures and encourage investment to expand the growth potential of the economy. Social expenditures will remain constant relative to GDP, government procurement procedures will be improved, and further reductions in government subsidies are scheduled. The main tax reform initiative will be the introduction of a value-added tax, while further efforts are being undertaken to strengthen tax administration.

Monetary policy under the program is designed to lower inflation and allow for a further increase in international reserves while satisfying legitimate credit needs within the economy. The extensive reforms undertaken since 1990 have markedly improved the functioning of financial markets. Consequently, during the program period, the National Bank of Poland intends to shift away from direct instruments of monetary control, notably the use of bank-specific credit ceilings, and rely instead on indirect instruments, especially open market operations.

Trade policies and exchange system reforms are aimed at furthering Poland's integration into the world economy. The highly efficient nonbank foreign exchange market (the "kantor" market) will be preserved in its current form during 1993, while the authorities take steps to deepen the official foreign exchange market. The remaining restrictions on current account transactions—including those on the repatriation of profits and capital in certain portfolio investments—will be removed. The Government is committed to a long-term strategy of lowering trade barriers. At the same time, Poland is also renegotiating its protocol of accession to the General Agreement on Tariffs and Trade to reflect its status as a market economy.

Rapid privatization of the state enterprise sector is the Government's top structural reform priority. Most state enterprises will, under pending legislation, have to opt for commercialization, privatization, or liquidation within six months or forfeit the right to choose their transformation path to the Ministry of Privatization.

Poland was an original member of the IMF, withdrew on March 14, 1950, and rejoined on June 12, 1986. Poland's quota is SDR 988.5 million (about $1.36 billion), and its outstanding financial obligations to the IMF resulting from past operations and transactions currently total the equivalent of SDR 596.6 million (about $821 million).

Press Release No. 93/10, March 8

NATIONAL ECONOMIES

Spain Has Benefited from Structural Reform And Membership in the EC, Says IMF Study

Although Spain has clearly benefited from its 1986 accession to the European Community (EC), it should be kept in mind that the groundwork for Spain's recent economic successes was laid during the preceding decades as the authorities initiated and followed through on a comprehensive process of stabilization and structural reform, according to a recently published IMF Occasional Paper.

Chapters in *Spain: Converging with the European Community* by IMF economists Michel Galy, Gonzalo Pastor, and Thierry Pujol include an overview of the opening up of the Spanish economy that occurred from 1950 to 1991, as well as discussions of financial liberalization, the external constraints on monetary management, personal income tax reform, and how fiscal decentralization has proceeded. A technical appendix analyzes aspects of the persistent divergence in inflation rates between the industrial and nonindustrial sectors in Spain.

The paper asserts that many of Spain's economic reforms grew out of its shift, beginning in the late 1950s, from political and economic autarky to integration with the rest of Europe and the broad international community. One important initial step that it took on the road to reform was joining the IMF in 1958 and, in the context of a 1959 balance of payments crisis, working with it to develop and implement a three-year economic stabilization plan.

Developments During 1960–73

In an overview chapter, Michel Galy notes that this plan was successfully implemented, creating the conditions necessary for sustained long-term growth. In fact, Spain's real output expanded by 7 percent annually during 1960–73, compared with roughly 4 percent annually during the 1950s. During 1960–73, the composition of output also changed considerably: the share of agriculture in total output decreased by 10 percent, while the share of the services sector increased by the same percentage.

Foreign investment lured by Spain's low labor costs gave the economy a significant boost, with gross capital inflows increasing by 20 percent annually during the period. The buoyant economy experienced significant inflation, with the GDP deflator increasing by 7 percent annually. As trade flows were progressively liberalized, the sum of Spain's exports and imports grew to 14 percent of GDP in the early 1970s. Meanwhile the current account balance moved from a deficit of 2.7 percent of GDP in 1960 to a surplus of almost 2 percent in the early 1970s.

Galy observes that Spain's strong growth in the first years of the 1970s masked several serious weaknesses in its economy that were brought into high relief by the oil crises of 1973 and 1979. First, the industrial sector was made up of small and medium-sized firms that were protected against domestic and foreign competition and had "weak financial, economic, and technical structures." Second, the recent entry of many former agricultural workers into the labor force exceeded industry's employment capacity.

Third, the financial system was "dominated by banking intermediation that was highly regulated and segmented with largely administered in-

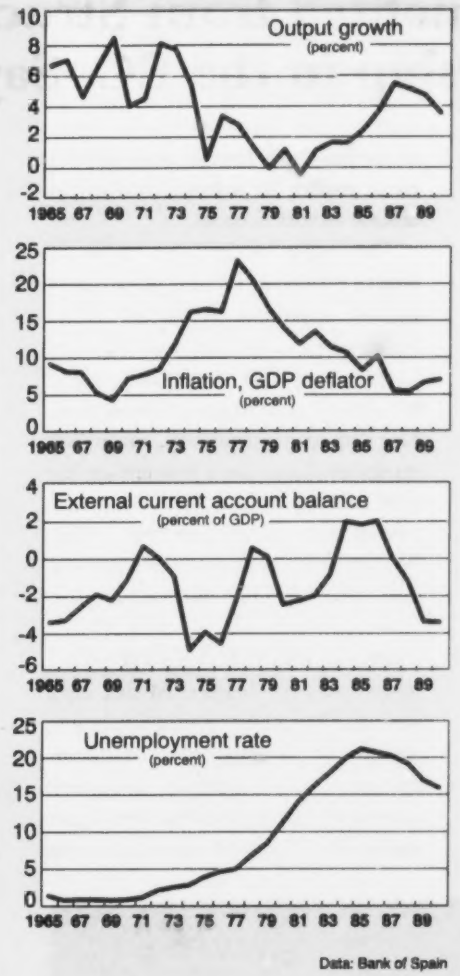
Port facilities in Barcelona: since joining the EC in 1986, Spain has increased the share of its total trade carried on with EC countries.

terest rates preventing competition between banks and providing low remuneration of savings." Fourth, the public sector "maintained a tight grip on the economy through financial policies and overwhelming intervention in all economic sectors." Fifth, Spain's external sector was heavily protected by a web of trade and foreign exchange regulations. Sixth, during its industrial buildup in the 1950s and 1960s, Spain had gradually shifted away from its traditional reliance on coal as an energy source and toward greater use of oil, leaving its economy highly dependent on imported energy.

Effects of 1973 Oil Crisis

Galy observes that the Spanish authorities, like their counterparts in other industrial countries, initially underestimated the impact of oil price increases on the economy. With Spain's current account in surplus, they attempted to counter the effects of the shock by relaxing financial policies and using fiscal policy to stimulate the economy. Although this policy approach enabled Spain to keep its real GDP growing at 3.3 percent during 1974–77, compared with an average of only 2.2 percent for members of the Organization for Economic Cooperation and Development (OECD), this was achieved at a high cost. Spain's budget surplus moved from a surplus of 0.7 percent of GDP in 1973 to a deficit of 1 percent in 1977; its current account surplus of the early 1970s changed to a deficit averaging 3 percent of GDP during 1974–77; and its inflation rate went from 11.4 percent of GDP in 1973 to 24.5 percent in 1977.

Spain: Key Economic Indicators, 1965–90



The author explains that during the 1973–77 period, which was marked by the end of the Franco regime and the creation of democratic institutions, a social consensus was gradually built up that enabled the authorities to undertake a comprehensive adjustment program, including both stabilization and structural adjustment measures, in 1977.

The 1977 adjustment measures—which included a 20 percent devaluation of the peseta against the U.S. dollar, a relaxation of restrictions on laying off workers, fiscal reform designed to achieve a more neutral and equitable tax system and simplify Spain's tax structure, and reform of the monetary and financial system designed to strengthen market forces—met with considerable success. Inflation fell sharply, and average nominal wage increases dropped from 27 percent in 1977 to 17 percent in 1978 and 9 percent the following year. With the help of a buoyant international economic environment, the current account moved from a deficit of 4 percent of GDP in 1977 to a surplus of about 1 percent during both 1978 and 1979. At the same time, however, economic activity slowed during implementation of the adjustment program and, consequently, investment decreased, the employment situation worsened, and the budget deficit grew.

Effects of 1979 Oil Crisis

Since Spain's economy was already in recession, the initial effect of the second (1979) oil shock was to depress economic activity further. This time, the authorities decided not to prevent or limit the pass-through of oil price increases to domestic costs and prices. In order to contain inflationary pressures, they exercised monetary restraint and used incomes policy to limit wage increases, while allowing the budget deficit to expand.

The resulting monetary contraction, along with the accelerated obsolescence of Spain's capital stock owing to the oil price increases, depressed capital accumulation in the industrial sector and led to large increases in unemployment. The unemployment rate rose

from 8.6 percent in 1979 to 21.5 percent in 1985. In order to cope with massive unemployment and support necessary restructuring of Spain's industrial sector, the authorities allowed the budget deficit to increase from 2.1 percent of GDP in 1979 to 7 percent in 1985, implemented an industrial reconversion program covering about 30 percent of industrial activity, and adopted a strategy aimed at reducing the losses of public sector firms. They adopted an energy plan designed to reduce Spain's use of imported energy from about 70 percent in the early 1970s to 52 percent by 1992 by relying more heavily on domestic coal deposits and nuclear power plants.

They also made efforts to restructure the banking system, whose soundness had been seriously undermined by the above-mentioned decline in the industrial sector, in which Spanish banks traditionally had been heavily involved. In order to deal with the large current account deficit, the Spanish authorities adopted a policy of "rather benign neglect of the peseta," which depreciated by 53 percent in effective terms during 1979–85, and eased exchange restrictions on long-term capital inflows in 1983 and on foreign direct investment in 1985.

During 1980–85, these policies achieved some successes in quite difficult circumstances. Spain's GDP grew by 1.4 percent annually; inflation declined to 8.8 percent from 15.6 percent; labor productivity grew faster than real wages after 1979, with a differential of almost 2 percent annually seen during 1980–85; and the current account, which had recorded annual deficits of about 2.5 percent of GDP during 1980–83, recovered toward the end of that period.

Integration into the EC

Spain became a full member of the EC on January 1, 1986 and was given seven years to align its laws and regulations with the relevant EC directives. Galy comments that "as Spain entered the EC, the fundamental macroeconomic imbalances that had plagued the economy during the previous fifteen years had been eliminated and market mechanisms had largely replaced previously pervasive government interventions. The progressive opening up of the economy and structural reforms had alleviated rigidities in the goods and capital markets and provided for a deep restructuring of the industrial sector and the banking system."

Nonetheless, he points out, Spain still faced serious weaknesses in its labor, goods, and financial markets; these included excessive regulation, numerous inefficient public sector enterprises, private cartels thwarting competition, and a sharp drop in the ratio of national savings to GDP. Galy opines that "by opening the economy to EC competition, offering a vast market to Spanish producers, buttressing the credibility of Spain's financial policies by joining the ERM [exchange rate mechanism of the European Monetary System], and keeping up a sustained pace of structural reforms, the authorities expected to overcome these weaknesses. The remarkable results achieved over the period 1986–91 bear witness to the effectiveness of the strategy."

In an international economic environment that was favorable, at least until 1989, Spain's economic output expanded rapidly as investment soared and consumption increased considerably. This rapid growth enabled Spain to reduce the real gap between its economy and those of the core EC member countries.

Beginning in 1984 and 1985, Spain experienced increasing rates of return on capital assets after more than a decade of consecutive declines. Its EC accession also brought about a huge inflow of direct foreign investment spurred by the prospect of the single European market. The decline seen since 1973 in the industrial sector's share of total output moderated, and the combination of vigorous economic growth, a more flexible labor market, and a more subdued growth of real wages boosted employment growth. Spain's unemployment rate consequently dropped from 21.4 percent in 1985 to 15.8 percent in 1991.

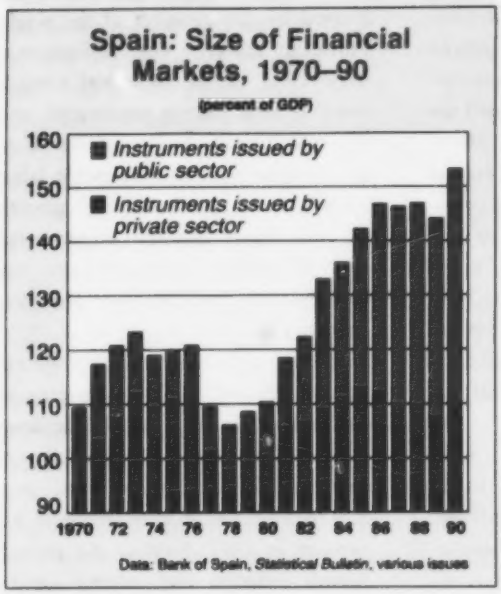
Spain's relatively rapid economic growth did not hinder its progress in reducing inflation, which declined from 8.8 percent in 1986 to 4.8 percent in 1987 before rising to 6.7 percent in 1990 and then subsiding to 5.9 percent in 1991. During this period, Spain's inflation rate moved significantly toward convergence with the inflation rates prevailing in the core EC countries. Its financial policies, which were also designed to facilitate economic convergence with other EC members, brought about a reduction in the budget deficit from 7 percent of GDP in 1985 to 2.7 percent in 1989, which was, however, followed by modest increases in 1990 and 1991. Since joining the EC, Spain has increased the share of its total trade carried on with the EC countries.

SDR Rates

Week Beginning	Rate of Interest and Charges (percent)
March 15	5.06
March 22	5.12

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department



Financial Liberalization

In a chapter on the liberalization of Spain's financial system, Gonzalo Pastor notes that "Spanish banking has been traditionally and until recently a closed system, heavily regulated, protected from foreign competition, conservative in terms of innovations, and controlled by the large banks, who also owned big portions of industry." Spanish banks had customarily paid their customers low rates on deposits and had been required to finance public deficits by purchasing low-yield government securities. Interest rates, bank branching, and the entry of new banks (including foreign banks) were strictly controlled; reserve requirements and investment coefficients put significant constraints on banks' investments; and different kinds of financial institution (for example, private commercial banks and savings banks) were regulated differently.

Liberalization of interest rates began in 1969, was expanded during 1974–77 for maturities of more than one year, and was completed in 1987. Since then, all interest rates have been free to fluctuate in response to market forces. Limits on new domestic banks' entry into the Spanish market were relaxed during 1974 but tightened during Spain's serious banking crisis of 1978–85. In 1988, the creation of new domestic banks was allowed for the first time since 1978.

An important part of the deregulation process in Spain has been the opening up of the domestic banking market to foreign competition. As of 1990, foreign banks were allowed to have a maximum of four branches each. They were then allowed to expand their branch networks to five in 1991 and seven in 1992. Furthermore, since 1992, the Spanish authorities have accepted entry into the Spanish market of any foreign bank that met the conditions specified in the EC's Second Banking Directive.

Limits on branching by domestic private commercial banks were liberalized in 1974, subject to capital-adequacy criteria. In 1975, limits on domestic savings banks' branching were liberalized within their geographic regions; in 1989, the liberalization was extended to permit branching in all of Spain.

Pastor concludes by noting that, as a result of the changes made over the past two decades, convergence to the single European market should, on balance, be beneficial for Spanish banks but cautions that they "need to globalize their operations so as better to service local firms and reduce their large operating costs at the same time that financial integration in Europe reduces their margins."

Copies of *Spain: Converging with the European Community*, which is No. 101 in the IMF's Occasional Paper series, are available for US$15.00 (US$12.00 for full-time college or university students and faculty members) from Publication Services, Box S-366, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

March 22, 1993 • Volume 22, Number 6

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The *IMF Survey* (ISSN 0047-083X) is published by the International Monetary Fund 23 times a year, ordinarily on alternate Mondays, in addition to an annual *Supplement on the Fund*, an annual Index, and other occasional supplements. Editions are also published in French (*Bulletin*) and Spanish (*Boletín*).The opinions and materials contained in the *IMF Survey*, including any legal aspects, do not necessarily reflect the official views of the IMF. Editorial correspondence should be addressed to Current Publications Division, Room IS5-1500, International Monetary Fund, Washington, D.C. 20431, U.S.A. Telephone: (202) 623-8585. The *IMF Survey* is distributed by first-class mail in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged an annual rate of US$60.00. Apply for subscriptions to Publication Services, Box S-99, IMF, Washington, D.C., 20431, U.S.A. Telephone: (202) 623-7430. Cable: Interfund Facsimile: (202) 623-7201.